

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SER:GEO:ATL:TL-N-608-99
EBJorgensen

date: **JUN 30 1999**

to: Chief, Quality Measurement Branch, Georgia District
Attn: Revenue Agent David Garrett, Stop 601-D

from: District Counsel, Georgia District, Atlanta

subject: Request for Advisory Opinion Regarding Specified Liability
Losses Under I.R.C. § 172(f)(1)(B)

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

With regard to your request, we held a presubmission conference by telephone with attorneys from the Field Service Division and the Corporate Division of the Chief Counsel's Office who had expertise regarding I.R.C. § 172(f) and who had reviewed the agent's request and materials. As a result of the conference, [REDACTED]

[REDACTED]

Issues

Set forth below are the items and the amounts for which you sought advice as to their deductibility under section 172(f) and that we discussed in the telephone conference:

1. [REDACTED] settlement/tort	\$ [REDACTED]	\$ [REDACTED]
2. Pension funding/prior service costs	[REDACTED]	[REDACTED]
3. Legal fees for age discrimination and anti-trust lawsuits	[REDACTED]	[REDACTED]
4. Look-back interest (interest for [REDACTED])	[REDACTED]	[REDACTED]
5. Workers compensation claims	[REDACTED]	[REDACTED]
6. State tax audits: sales tax & income tax audits	[REDACTED]	[REDACTED]
Less: [REDACTED] carryback limitations based on taxable income		([REDACTED])
Total carryback amounts	\$ [REDACTED] =====	\$ [REDACTED] =====

Pension funding/prior service costs

First, with regard to the deductibility under section 172(f) of the pension funding/prior service cost. [REDACTED]

, (b)(5)(AC), (b)(5)(DP)

Legal fees for age discrimination and antitrust lawsuits

With regard to the deductibility under section 172(f) of legal fees incurred in defense of an age discrimination law suit and an antitrust lawsuit, they recommended [REDACTED], (b)(5)(AC), (b)(5)(DP)

. They recommended that [REDACTED]

The National Office's current position is that attorney's fees relating to the defense of these type of suits do not qualify for the 10 year carryback under section 172(f) regardless of whether the underlying liabilities would have qualified.

We forwarded to the revenue agent an industry specialization paper on the deductibility of attorney's fees in various situations which we received from the National Office. Before this issue is submitted to the National Office, [REDACTED]

[REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)

Look-back interest

[REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)

Workmen's compensation claims

[REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)

Additional state sales and income taxes

With regard to the additional state sales and income taxes resulting from various state tax audits, the National Office's position is reflected in its briefs filed in the Intermet Corp. & Subs. v. Commissioner, 111 T.C. 294 (1998). We have enclosed copies of the relevant portions of the Intermet briefs. In the briefs, the National Office argued that Congress intended ten-year carryback treatment to apply to "certain" liabilities for which a deduction is delayed by the economic performance rules under I.R.C. § 461(h). Inherent in the nature of each type of identified liability, i. e. product liability and tort liability losses, is an element of substantial delay between the time the act giving rise to the liability occurs and the time a deduction may be claimed for the liability. This same analysis is

applicable to liabilities arising under a Federal or State law under section 172(f)(1)(B). Sealy v. Commissioner, 107 T.C. 177(1996), appeal docketed (6th Cir. March 31, 1998).

State taxes and the interest on state and federal taxes are not liabilities that involve an inherent delay between the time the liabilities are incurred and the time a deduction is claimed for the liability. I.R.C. § 461(h); Treas. Reg. § 1.461-4(g)(6)(i); and Treas. Reg. § 1.461-4(e). Deductible taxes and related interest are in the same general class of "routine" costs for which a ten year carryback was denied in the Sealy case.

In the Intermet case, the Tax Court never reached this issue because it decided the case on the issue of how specified liability losses are treated in determining a consolidated net operating loss. As you know, we subsequently lost United Dominion Indus., Inc. v. United States, 98-2 USTC ¶ 50,527(1998) on the same consolidated net operating/specified liability loss issue. A copy of that case is attached. The National Office believes that case was decided incorrectly. [REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED]

[REDACTED] settlement payments

[REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED]

[REDACTED]. These payments allegedly included lost profits of \$ [REDACTED]; actual/compensatory damages of \$ [REDACTED]; exemplary/punitive damages of \$ [REDACTED]; [REDACTED]'s legal fees of \$ [REDACTED]; expenses of developing a clean room of \$ [REDACTED]; external legal fees of \$ [REDACTED]; internal legal fees of \$ [REDACTED]; and interest related to deferred payments of \$ [REDACTED]. [REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED]

[REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED]

Discussion

Although we cannot give an opinion as to the deductibility of the settlement payments under section 172(f), we will address the following questions you raised.

Issues

1. Does the [REDACTED] matter qualify as a tort?
2. If there is a tort, have the four qualifications of section 172(f)(1)(B)(ii) been met?
3. Do legal expenses and other related costs associated with the [REDACTED] matter qualify under section 172(f)?
4. Does the [REDACTED] matter qualify under section 172(f)(1)(B) as a liability arising under state law?
5. Under California law, is it possible for a portion of the taxpayer's actions to be considered as a breach of contract with the balance as either a tort action or a liability arising under state law? In other words, could the arbitration award and the settlement agreement amounts be allocated?

Conclusions

1. The punitive damage award of \$[REDACTED] by the Arbitration Board is based on tort, not breach of contract, according to the Arbitration Board's Opinion.
2. [REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)
3. [REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)
4. The Arbitration awards are based on California law. [REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)
5. The Arbitration Board in its Opinion awarded \$[REDACTED] in compensatory damages apparently for breach of contract and \$[REDACTED] for punitive damages apparently for a tort action. (Copies of the pleadings would help to make this clear.) The arbitration award therefore is already allocated. The settlement award should be allocated based on the audit techniques position paper already furnished to the agent by the National Office. [REDACTED]
[REDACTED], (b)(5)(AC), (b)(5)(DP)

, (b)(5)(AC), (b)(5)(DP)

Facts

_____ sued _____ in _____ in the Northern District of California for breach of contract. Pursuant to the contract, the case was sent to arbitration to determine if there were any damages and, if so, how much. In an Arbitration Board Opinion on _____, the Arbitration Board determined that _____ was entitled to damages for lost profits of \$_____. It also determined that _____'s compensation for _____'s misuse of protected information under the contract and the value of the advantage gained by _____ by that misuse was \$_____. It awarded punitive damages of \$_____ for breach of the implied covenant of good faith and fair dealing and for unfair trade practices because it felt the conduct of the breaching party (_____) was so oppressive as to deserve a penalty for the purpose of deterrence.

Later in _____, the parties entered into a license and settlement agreement. In that agreement, they treated the \$_____ as a form of royalties to be paid by _____ for producing and selling _____'s devices that were subject to the original contract.

Legal Analysis

In every contract there is an implied covenant of good faith and fair dealing. A breach of the contract results from a failure to comply with the implied covenant of good faith and fair dealing. Where the breach of the implied covenant of good faith and fair dealing is malicious then an independent tort can arise. As a general rule damages for breach of contract are limited to the actual loss suffered. 17 Am. Jur. 2d, Contracts, Section 380 (1996).

Punitive or exemplary damages are not ordinarily recoverable in actions for breach of contract. There is an exception to this rule in those exceptional cases where the breach amounts to an independent, willful tort. In that event exemplary damages may be recovered under proper allegations of malice, wantonness, or oppression. 22 Am Jur 2d, Damages, Section 752 (1996).

California does not allow punitive damages for breach of contract, except where there is an independent willful tort involving malice, wantonness or oppression. California Civil Code § 3294. The Arbitration Board in the instant case treated the

violation of the implied covenant of good faith and fair dealing as giving rise to an independent willful tort. Based on properly supported allegations of malice and oppression, the Board awarded punitive damages of \$ [REDACTED].

We have included a copy of California Civil Code § 3294 and case annotations thereunder. Exemplary or punitive damages are permitted under section 3294(a): "[I]n an action for the breach of an obligation not arising from contract, where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant."

Under section 3294, the annotation "18. Breach of Contract" contains cases that hold that punitive damages may not be granted in actions based on breach of contract even though the breach was willful and fraudulent. But under the annotation "19. Incidental Tort" the cited cases establish that where the action is one in tort, punitive damages may be recovered on a proper showing of malice, fraud, or oppression, even though the conduct constituting the tort also involves a breach of contract. Additional cases supporting this proposition are also found under the annotation "24. Fraud-Undue Influence."

One of your questions is whether [REDACTED]'s breach of contract also qualifies as a tort. [REDACTED], (b)(5)(AC)

[REDACTED]

You asked if the arbitration award and the settlement agreement amounts may be allocated. To provide a definitive answer, [REDACTED]

[REDACTED], (b)(5)(AC)

[REDACTED]

The arbitration awards are based on California law because in the additional findings of fact and conclusions of law supporting the arbitration awards, the Arbitration Board cites in support of its Opinion and damage awards: California Business

and Professional Code §§ 17200 and 17203, California Civil Code §§ 3426(1)(d), 3246.1(a), and 3246.2(a), and various California cases. We have attached copies of the California statutes and cases mentioned in the Arbitration Opinion and other California statutes, regarding breach of contract and torts related to breach of contract.

We are closing our file. If we can be of further assistance, please contact the undersigned at telephone no. (404) 338-7945.


ERIC B. JORGENSEN
Senior Attorney

Attachments as stated.

✓ cc: Assistant Chief Counsel (Field Service) (w/o attachments)
cc: Assistant Regional Counsel (Tax Litigation) (w/o attachments)
Southeast Region, Stop 180-R
cc: TL Cats (w/o attachments)